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Before the  
FEDERAL COMMUNICATIONS COMMISSION  
Washington, D.C. 20554

SEP 2 1998

FEDERAL COMMUNICATIONS COMMISSION  
WASHINGTON, D.C. 20554

In the Matter of	)	
	)	
Petition for Rulemaking to Amend	)	
Part 32 of the Commission's Rules,	)	RM-9341
Uniform System of Accounts for	)	
Class A and Class B Telephone	)	
Companies to Adopt the Accounting	)	
for Software Required By Statement	)	
of Position 98-1	)	

REPLY COMMENTS OF SOUTHWESTERN BELL TELEPHONE COMPANY,  
PACIFIC BELL AND NEVADA BELL

Southwestern Bell Telephone Company, Pacific Bell and Nevada Bell (the "SBC LECs"), pursuant to Public Notice,<sup>1</sup> hereby file their Reply Comments in connection with the Petition for Rulemaking (the "Petition") filed by BellSouth and Bell Atlantic on August 3, 1998.

All of the commenters agree that the Commission should permit incumbent local exchange carriers ("ILECs") to adopt the recent changes in generally accepted accounting principles ("GAAP") for software for purposes of Part 32.<sup>2</sup> However, MCI maintains that Statement of Position 98-1 ("SOP 98-1") should not be adopted in its entirety for purposes of Part 32. MCI contends that Part 32 should continue to distinguish between initial operating system software and application software and that the former should be capitalized whether or

<sup>1</sup> Public Notice, RM-9341, DA 98-1625, released August 13, 1998.

<sup>2</sup> See, e.g., Ameritech at 1; MCI at 2.

not SOP 98-1 would require capitalization.<sup>3</sup> Partial adoption of SOP 98-1 would defeat one of the main purposes of conforming Part 32 principles to GAAP because any differences between Part 32 and GAAP would force ILECs to incur the extraordinary burden of divergent accounting treatment of software, such as capitalizing in Part 32 what must be expensed for external, financial reporting purposes consistent with GAAP.<sup>4</sup>

To avoid such complex accounting procedures and to reduce the burden of unnecessary accounting regulation, the Commission should simply adopt SOP 98-1 and allow ILECs to rely on it as the sole source of guidance for software accounting. As explained in the SBC LECs' initial Comments, the Commission should use a simple method of adopting SOP 98-1 such as forbearance or a simple rule amendment.<sup>5</sup> The Commission could simply amend Part 32 to permit ILECs to follow SOP 98-1 in its entirety, notwithstanding any other provision of Part 32.<sup>6</sup> Revision of multiple Part 32 provisions, as suggested by the Petition<sup>7</sup> and MCI's Comments,<sup>8</sup> is not necessary, if the Commission simply adopts this one rule change or takes similar action to

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<sup>3</sup> MCI at 3-4.

<sup>4</sup> GTE at 3; SBC LECs at 1-2 & n. 3.

<sup>5</sup> SBC LECs at 2-3.

<sup>6</sup> Id. at 2. The Commission would also need to designate Account 2690 as the proper account to use in recording capitalized software. Id.

<sup>7</sup> Petition, Attachment 1.

<sup>8</sup> MCI, Attachment 1.

forbear from applying any Part 32 requirements to software to the extent they differ from SOP 98-1.

The main reason MCI provides for urging the Commission to adopt a non-GAAP method of accounting for software is a desire to maintain the status quo. For example, MCI says that “cost allocations will remain undisturbed and straight-forward [and] service cost studies . . . will also remain undisturbed and straight-forward.”<sup>9</sup> What MCI fails to realize is that SOP 98-1 will largely maintain the status quo for initial operating system software. First, SOP 98-1 was adopted on a prospective basis. As SOP 98-1 indicates, it should be applied to internal-use computer software costs incurred in fiscal years beginning after December 15, 1998.<sup>10</sup> Thus, the embedded base of capitalized software is largely unaffected by SOP 98-1. Besides, especially for price cap ILECs, any resulting changes in cost allocation and Part 32 accounting for software would have little, if any, relevance to rate-setting or other regulatory processes. In any event, the accounting for initial operating system software would not be any different because such software would be considered internal-use software, and thus, it would be capitalized under SOP 98-1 as it would be under current Part 32 rules.

While MCI argues to retain the current Part 32 treatment for initial operating system software based in part on a status quo rationale, it inconsistently takes the position that upgrades to such operating system software should be capitalized in accordance with SOP 98-1.<sup>11</sup> That is,

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<sup>9</sup> MCI at 4 (emphasis added).

<sup>10</sup> SOP 98-1, ¶42.

<sup>11</sup> MCI at 3-4.

MCI's proposal would not completely maintain the status quo and thus it is internally inconsistent.

MCI also vaguely contends that SOP 98-1 would "severely complicate" cost allocation and service cost studies.<sup>12</sup> On the contrary, the principles of SOP 98-1 are relatively simple. Mechanisms such as the Part 64 cost allocation manual ("CAM") can easily handle this accounting change just as it has adapted to previous changes in Part 32 accounting. There is simply no reason to believe that mechanisms such as CAM could not easily accommodate the changes in capitalization of software under SOP 98-1. What would be severely complicated and burdensome would be to require ILECs to have capitalization procedures for regulatory purposes that are significantly different from those used in external GAAP reporting.<sup>13</sup>

MCI admits that the economic life of application software is unpredictable.<sup>14</sup> This is a characteristic shared by all software, as in the case of most intangible assets. As stated in Accounting Principles Board ("APB") Opinion No. 17

its lack of physical qualities makes evidence of its existence elusive, its value is often difficult to estimate, and its useful life may be indeterminable.<sup>15</sup>

The useful life of operating system software is likely to be substantially less than the life of its

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<sup>12</sup> Id. at 4.

<sup>13</sup> See Arthur Andersen LLP, "Accounting Simplification in the Telecommunications Industry," filed July 15, 1998 at 16-24.

<sup>14</sup> MCI at 7.

<sup>15</sup> APB Opinion No. 17, ¶12.

associated hardware. Thus, it would not be reasonable to assume that the hardware and software have the same useful lives, as MCI suggests.

In view of the Section 11 mandate to eliminate unnecessary regulation,<sup>16</sup> the Commission should not dictate the amortization periods for any type of capitalized software. Instead, price cap ILECs should be allowed to determine the amortization periods for software consistent with GAAP and SOP 98-1. This approach to software is especially appropriate, given that any prescribed lives would be arbitrary where individual lives are so uncertain. Likewise, the Commission should not set an expense limit for software. Instead, each ILEC should be free to set an expense limit consistent with GAAP. If the Commission decides not to permit ILECs to set their own expense limits at this time, then the Commission should at least adopt an expense limit that properly weighs the administrative cost against any perceived benefit of tracking relatively small value items. The benefits of such micromanagement are very minimal in the case of price cap ILECs. Further, given the intangible nature of software, tracking small value "units" is even less meaningful than a tangible unit that one can physically examine.

MCI also argues that initial operating system software should be included in the cost of personal computers ("PCs") for purposes of determining whether they should be expensed under the \$500 expense limit for General Purpose Computers booked in Account 2124.<sup>17</sup> MCI apparently believes that failure to capitalize low-value operating system software would result in fewer PCs being capitalized. In reality, whether or not operating system software is capitalized

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<sup>16</sup> 47 U.S.C. §161.

<sup>17</sup> MCI at 8.

will have little, if any, effect on the capitalization of PCs. The \$500 expense limit on PCs is so low that it ensures that they will almost always be capitalized, with or without the operating system software cost. While the SBC LECs do not agree with the \$500 expense limit for PCs because it is too low, that regulation is not a reason to establish a low expense limit for capitalized software or to require all initial operating system software to be capitalized.

MCI correctly recognizes that an exogenous price cap adjustment would not be triggered by this accounting change because it would not have a direct impact on the ILECs' cash flow.<sup>18</sup> Mainly, it is merely a change in how accounting books are kept and the timing of the recognition of costs, not an economic cost change that one would expect to affect prices in a competitive market. In fact, under price caps, there would be no impact on rate-setting. Thus, for an ILEC under price cap regulation, a revenue requirement study would be completely meaningless. Price cap ILECs no longer have "revenue requirements"; rather, they have capped rates. Thus, it is illogical for MCI to oppose relief from the revenue requirement study for price cap ILECs, especially given its recognition that price cap rates would not be affected by this accounting change.<sup>19</sup>

For the foregoing reasons, the Commission should reject MCI's efforts to incorporate in Part 32 a modified version of the GAAP principles for software accounting when GAAP alone would be sufficient. Instead of perpetuating the burden of the differences between regulatory and

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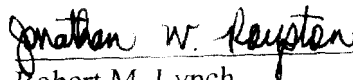
<sup>18</sup> MCI at 7.

<sup>19</sup> Why MCI thinks "all . . . ILECs have undoubtedly done such studies months ago for internal use," MCI at 2, is baffling. Price cap ILECs would have no reason to perform such studies and would not waste resources doing so. Further, if all ILECs had already done such studies, then price cap ILECs like Bell Atlantic and BellSouth would have no reason to seek a waiver to avoid the worthless exercise. Again, the logic of MCI's argument is elusive.

GAAP accounting, as MCI seeks, the Commission should take action promptly to ease the burden of unnecessary regulation by permitting ILECs to begin following SOP 98-1 under Part 32 effective January 1999.

Respectfully submitted,

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September 28, 1998

## CERTIFICATE OF SERVICE

I, Katie M. Turner, hereby certify that the foregoing, "RM-9341, REPLY COMMENTS OF SOUTHWESTERN BELL TELEPHONE COMPANY, PACIFIC BELL AND NEVADA BELL IN THE MATTER OF PETITION FOR RULEMAKING TO AMEND PART 32 OF THE COMMISSION'S RULES, UNIFORM SYSTEM OF ACCOUNTS FOR CLASS A AND CLASS B TELEPHONE COMPANIES TO ADOPT THE ACCOUNTING FOR SOFTWARE REQUIRED BY STATEMENT OF POSITION 98-1" in RM No. 9341 has been filed this 28<sup>th</sup> day of September, 1998 to the Parties of Record.

A handwritten signature in cursive script, reading "Katie M. Turner", written over a horizontal line.

Katie M. Turner

September 28, 1998

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